COUNTY OF MILWAUKEE
Inter-Office Communication

Date: July 12, 2002

To: Karen M. Ordinans, Chairman, Milwaukee County Board of Supervisors

From: Jerome J. Heer, Director of Audits

Subject: Employees' Retirement System Actuary Contract

Background

In the aftermath of the recent Milwaukee County pension controversy, numerous questions have been raised concerning the role of the actuary in providing information relevant to decisions on major pension benefit changes. The Milwaukee County Employees' Retirement System (ERS) has had a contractual relationship with its current actuary, William M. Mercer, Inc. (Mercer) since 1987. At that time, Mercer had merged with A. S. Hansen, Inc., which had provided actuary services for the ERS since at least 1968. Mercer is a wholly owned subsidiary of Marsh & McLennan Companies, Inc. (MMC). Under MMC, Mercer was part of the Mercer Consulting Group, which included Mercer Investment Consulting, Inc. (MIC) as a wholly owned subsidiary of Mercer. MIC has provided investment consulting services to the ERS Pension Board since 1990. In 2002, Mercer changed its corporate name to Mercer Human Resources Consulting.

In 1991, the Pension Board sought competitive bids for actuary services. Four firms competed and ultimately the review committee recommended retaining Mercer. No competitive proposals have been sought since that time.

Payments

Payments from the ERS to Mercer for investment consulting services totaled $164,043 in 2000 and $160,200 in 2001.

For 2000 and 2001, the actuary contract specified an annual fee of $47,500 for various services enumerated in the agreement, including:

1. Completion and delivery of the annual actuarial valuation report for ERS;
2. Completion and delivery of the annual actuarial valuation report for OBRA;

3. Preparation of estimated contribution requirements for the following year;

4. Preparation of audit materials as they directly relate to ERS and OBRA as requested by the Pension Board;

5. Attendance at annual meeting to discuss valuation results;

6. Calculation of up to six benefit amounts each year as requested by the Pension Board pursuant to Rule 1013(a)(4) of the Pension Board; and

7. Consulting assistance with benefit calculations, but exclusive of the completion of such calculations other than calculations pursuant to Rule 1013(a)(4) of the Pension Board.

The contract also allowed payment for other services not specified in the agreement, based on a range of hourly rates for different contractor staff position titles.

During the same 2000—2001 time period, the former Director of Human Resources also entered into a separate contractual relationship with Mercer. These professional service agreements were for the provision of pension-related actuarial analysis and ad hoc oral and written reports to the Director as needed during labor negotiations, budget preparations and in response to requests from Milwaukee County department heads and elected officials. By using the same actuarial firm as the ERS for provision of these services for the Department of Human Resources (DHR), the County is able to take advantage of the actuary's familiarity with County data and is assured consistency in the analysis of potential benefit changes.

Payments to Mercer for actuary services under contracts with both the ERS and the Department of Human Resources totaled more than $140,000 annually in 2000 and 2001, as shown in **Table 1**.

Table 1
Milwaukee County Payments to
William M. Mercer, Inc. for
Actuary Services
2000 and 2001

	2000			**2001**		
	ERS	**Human Resources**	**Total**	**ERS**	**Human Resources**	**Total**
Actuarial Services	$47,500	$85,674	$133,174	$47,500	$62,650	$110,150
Other (Special) Services	11,250	0	11,250	33,173	0	33,173
Total	**$58,750**	**$85,674**	**$144,424**	**$80,673**	**$62,650**	**$143,323**

Source: Milwaukee County Accounts Payable and Employees' Retirement System records.

During the course of providing these services, Mercer billed ERS on ten occasions for services requested by the Director of Human Resources. In turn, ERS offset these charges against regular monthly payments made by the ERS to Milwaukee County for administrative expenses (primarily staff and payroll processing costs). The charges for actuarial and special services provided on behalf of the Director of Human Resources totaled $38,373 in 2000 and $22,750 in 2001. Under the agreements with the Department Human Resources, Mercer received total compensation of $85,674 (2000) and $62,650 (2001), which includes the charges billed to ERS.

The effect of processing and recording these charges in this manner was to understate DHR revenue for administrative support provided to the ERS, and to understate DHR expenses associated with services Mercer provided. As such, DHR was able to exceed contractual professional service dollar limits without obtaining County Board approval.

To avoid this understatement of DHR revenues and expenses in the future, we recommend that both the ERS and DHR:

1. *Submit any service requests to the actuary in writing and that the written requests specify who is requesting the service, and under which contractual agreement.*

2. *Require separate invoices for services rendered on their behalf.*

Data and Methodology

To provide the required contractual services, Mercer uses a database of historical information regarding active and retired employees provided by Milwaukee County. While Mercer maintains and updates the database each year with information provided by Milwaukee County, the County owns and would retain the database in the event of a change in actuarial firms. Active plan participants are divided into three categories, General, Deputy Sheriffs and Elected. Actuarial assumptions related to retirement ages, earnings progression, separation and withdrawal rates are based on actual Milwaukee County experience. Mortality rates are based on published tables.

The recently enacted back DROP (Deferred Retirement Option Program) feature provided individuals, upon retirement, with the option of obtaining a lump-sum payment for a portion of their pension payout, while receiving reduced monthly pension payments thereafter. The usage rate used by the actuary to estimate future pension costs associated with the back DROP option is based on recent experience since its inception in 2001.

According to Section 201.24 (5.16) of the Milwaukee County General Ordinances, the back DROP interest rate is tied to the pension fund's assumed rate of return adopted by the Pension Board. In September 2001, the Pension Board adopted the policy of basing the assumed annual investment return on a ten-year average of the actual return, with a floor of 7.5% and a cap of 9.0%. Based on this policy, the assumed rate of return used to compute the 2002 contribution was 9%. Although Mercer described this rate of return as aggressive it also pointed out that it was not unrealistic based on the pension fund's experience of the last 20 years. According to a recent study prepared for the State of Wisconsin, assumed rate of returns averaged 8.02% among 84 government pension systems surveyed in 2000, with 57 plans between 7%—8% and 27 plans exceeding 8%.

Mercer uses the aggregate entry age normal method of funding to compute liabilities and contributions. The objective under this method is to fund all pension plan benefits in installments which are level as a percentage of each group's aggregate salary, starting at the original participation dates and continuing until the assumed retirements, terminations, disabilities or deaths. This method is a conventional, widely accepted actuary method.

In determining the value of the pension plan's assets, Mercer uses a five-year moving average where 20% of the prior four years' unrealized gains or losses are recognized annually. The funding period Mercer currently uses is 20 years, which was adopted by the Pension Board in September 2001**.** Again, these are widely accepted actuary conventions.

Cost of Enhanced Pension Benefits

The cost of enhanced pension benefits included in the 2001—2004 County wage and benefit package has been addressed in several documents, including:

- *Sick Leave Payouts* memo issued by the Director of Audits and Director of County Board Research (January, 2002). Contains estimates of total costs associated with sick leave payouts approved in County 2001—2004 wage and benefit package.

- *Audit of Milwaukee County's Development and Adoption of 2001—2004 Wage and Benefit Package* (April, 2002). Contains calculation of total costs associated with approval of the package.

- *Salary Survey of Selected Top Managers and Elected Officials* issued by the Department of Audit (April, 2002). Contains a comparison of sick leave benefits, pension benefits and employee health care premium contributions among various government jurisdictions.

- *County Contribution to the Employees' Retirement System and OBRA 1990 Retirement System* memo from ERS and with attachments from Mercer (May, 2002). Contains a breakout of various components resulting in recommended County contribution to ERS/OBRA of $20.8 million for 2003.

- *Handout on Pension Plan Status* issued with a memo from the Fiscal and Budget Administrator and Controller (June, 2002). Contains an analysis to apportion costs of recommended County contribution to ERS for 2003 between changes in benefits, normal system growth requirements and negative market returns.

Potentially Significant Error

As noted in our *Audit of Milwaukee County's Development and Adoption of 2001—2004 Wage and Benefit Package* (April 2002), the resolutions adopted by the County Board implementing the package contained a provision which limits pension payments as defined in Section 415 of the Internal Revenue Service (IRS) Code. This section of the Code places caps on the maximum annual pension payments that can be paid under the County's pension plan. For 2002, that annual limit is generally $160,000. Specific reference is made in the language adopted by the County Board to include back DROP payments in the calculation of the limits. This is accomplished by developing an actuarial value of a lump sum back DROP amount, which is added to the reduced pension to determine compliance with the cap. Given that the limit is such a significant amount, the vast majority of County employees do not come anywhere near the cap. However, the impact of noncompliance with the Code is significant because failure to comply could place the tax-exempt status of the plan in jeopardy.

Because of the importance of following Section 415 of the IRS Code, staff of the ERS worked closely with Mercer to ensure that annual limits were accounted for in calculating monthly pensions and back DROP amounts. By March 2001, ERS staff were verifying calculations against a table to gauge compliance. According to ERS staff, it was subsequently determined in December 2001 that the table provided by the actuary, and in use until that time, was not the proper schedule given the structure of the Milwaukee County pension plan. We conducted a review of pension calculations to determine whether any payments were issued in conflict with the Code and County Ordinances, and hired an independent actuary to make separate calculations for verification purposes. We concluded that, although a table reflecting inappropriate limits was used prior to December 2001, there were no pension calculations that resulted in payments exceeding Section 415 caps. However, this was a significant error on the part of the actuary and, left undetected, could have had potentially costly implications for Milwaukee County.

Conclusions

The relationship between the actuarial firm and Milwaukee County differs slightly depending on the services provided. In its capacity as investment advisor and actuary for the ERS, Mercer serves the Pension Board on behalf of plan participants. The nature of the ERS service includes both the provision of factual information and, on occasion, advice. Services to the Department of Human Resources include cost estimates for various pension scenarios. These estimates are used by management in developing potential wage and benefit packages for represented and non-represented employees. Regardless of the service that is provided, the firm is guided by professional standards. We see no inherent conflict in Mercer's investment advisory and actuarial services to the ERS and DHR. We are, however, concerned about the length of time that has passed since the last solicitation of proposals for actuarial services (1990). Therefore, we recommend that the ERS:

3. *Solicit competitive proposals for actuarial services. We believe that a contract period of five years would be more appropriate than the current open-ended arrangement.*

Based on this process, we believe it would be appropriate for DHR to 'piggyback' onto this arrangement, under a separate contract, for its actuarial services.

While we conclude that the actuary did not act improperly in the development of the 2001—2004 wage and benefit process, new contract provisions may strengthen accountability in this important area. For example, we have already recommended that all requests for actuarial services be in writing. This would establish a clear trail of requested information on benefit changes.

Further, accountability could be improved by broadening the flow of information in certain situations. For example, it may be appropriate to require that a copy of all responses to inquiries by the actuary be provided to elected officials at the time that proposed ordinances affecting pension benefits are submitted for approval. Additionally, providing the Pension Study Commission the ability to directly access information, including analytical reports and calculations, from the ERS actuary would provide the opportunity for enhanced and more insightful scrutiny over proposed pension benefit changes. Therefore, we recommend that DHR:

4. *Provide the County Executive and County Board with all relevant responses to inquiries provided by the ERS actuary whenever proposed ordinances affecting pension benefits are submitted for approval.*

Further, we recommend that DHR:

5. *Include in its contract with the ERS actuary a provision permitting direct access by the Pension Study Commission to information, analysis and consultation from the actuary.*

Other relevant suggestions for strengthening the process were included in our April 2002 audit of the wage and benefit package, including:

- Early input from the Controller, at the beginning at the point at which an overall negotiating strategy is agreed upon;
- Advance notice, including material for review, of at least 30 days for any proposed pension changes presented to the Pension Study Commission; and
- A requirement that any queries by the County concerning the estimated costs of proposed pension benefit changes be based on the existing actuarial assumed rate of return for the pension fund. If a best and worst case scenario is desired, the range should be requested of the actuary based on the actuary's best judgement, not articulated by the County.

The Greater Milwaukee Committee (GMC) Select Committee on Milwaukee County Government will also be addressing this matter.

Please refer this memo to the Committee on Finance and Audit.

Jerome J. Heer

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JJH/cah

cc: Milwaukee County Board of Supervisors
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